PRICEWATERHOUSECOOPERS

Report to the Washington State, Office of Insurance Commissioner On Tax Matters in Connection with the Proposed Conversion of Premera

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October 27, 2003

Prepared for the Washington Office of the Insurance Commissioner

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I. Nature and Scope of Engagement

PricewaterhouseCoopers LLP ("PricewaterhouseCoopers" or "PwC") has been engaged by the State of Washington, Office of Insurance Commissioner ("OIC" or "Agency") to assist the OIC staff in evaluating the tax aspects of the proposed conversion of Premera ("Company") from a non-profit, non-stock entity to a for-profit stock entity ("Conversion Transaction"), including the tax implications associated with the Foundation(s) and related Charitable Organization(s) as proposed by Premera.

PricewaterhouseCoopers has performed analyses of certain historical and prospective tax and financial information and other data for the Company (the "Services") solely to assist the OIC in its evaluation. The Services performed by PwC were based upon instructions contained in Section 3.4 of the Agency's Request for Proposal dated August 2, 2002 (the "RFP"), and as further modified and defined in PwC's September 4, 2002 response to the RFP.

In connection with the performance of these Services, PricewaterhouseCoopers requested access to certain documents including the Form A filing with the OIC, tax opinions, internal and external communications and analyses relating to the tax aspects of the Conversion Transaction, ruling requests, prior year federal and state income tax returns, premium tax returns, prior year tax accrual working papers, and other information deemed relevant for this analysis (See the Document Request Matrix for full list of requested information). PricewaterhouseCoopers was not provided access to all requested documents and information as, in many cases, Premera has asserted Attorney-Client or Work Product Privilege over the information (See Privilege Log for listing of documents for which PwC was not provided access). As a result, PricewaterhouseCoopers LLP is not in a position to fully assess and evaluate the potential tax issues and risks associated with the Conversion Transaction.

PricewaterhouseCoopers also met with various employees and outside advisors of Premera during the course of this engagement to make specific inquiries based on our review of the documents provided and our experiences in other similar transactions.

The purpose of these requests and inquiries was to develop an understanding of the key tax issues and risks associated with the Conversion Transaction and their potential impact on the Company, the Foundation(s) and Charitable Organization(s).

II. Executive Summary

The following executive summary provides an overview of the significant tax issues identified during the review process.

A. Tax-Free Treatment of Conversion

Premera intends to rely on a tax opinion from Ernst & Young LLP ("E&Y") that the Conversion Transaction "will" be treated as a series of tax-free transactions for federal income tax purposes. The tax opinion is currently in draft form.

While we express no opinion on the tax-free treatment of the conversion, we do not find the "draft" tax opinions issued by E&Y to be unreasonable. While a favorable private letter ruling would provide certainty with respect to this matter, the "will" tax opinion issued by E&Y provides a relatively high level of assurance. Consequently, we do not believe that it is unreasonable for Premera to rely on tax opinions of this nature for purposes of obtaining comfort with respect to this issue.

B. Possible Loss of Blue Cross and Blue Shield Federal Tax Benefits

Existing Blue Cross and Blue Shield ("BCBS") organizations are granted certain special benefits for federal income tax purposes. These special tax benefits are only available to existing BCBS organizations that have not experienced a "material change in structure or operations". If it is determined that Premera experiences a "material change in structure" as a result of the Conversion Transaction, then significant tax benefits will be lost which will cause the financial statement effective tax rate ("effective tax rate") to increase from approximately 20 percent to approximately 35 percent (representing a 75 percent increase in the effective tax rate), and will increase the "cash" tax paid to the IRS in subsequent years based on projected financial results.

Premera intends to rely on a tax opinion from E&Y that the Conversion Transaction "more likely than not" will not result in Premera experiencing a "material change in structure or operations". A "more likely than not" opinion is generally viewed as a more than 50 percent chance of sustaining a tax position, and a relatively low level of assurance for important tax issues associated with a transaction of this nature.

The E&Y tax opinion is a "short form" tax opinion that has not been issued in final form. A "short form" tax opinion does not include a well-reasoned analysis of the tax issues.

We believe there are arguments that could be made to support the position that the Conversion Transaction should not cause Premera to experience a "material change in structure". However, there is considerable uncertainty surrounding this issue given the lack of direct authority and the IRS' view on this matter. Accordingly, the risk of Premera experiencing a "material change in structure", and attendant loss of tax benefits, is significant and must be considered by the OIC in evaluating the potential negative financial impact to the company, policyholders, and public as a result of the Conversion Transaction.

C. Restrictions of Tax Attributes Under Section 382 of the Code

If it is determined that the Conversion Transaction or a subsequent stock sale results in an "ownership change", future utilization of tax attributes such as net operating loss carryovers, alternative minimum tax credit carryovers, and built-in losses (generally defined as the excess of tax basis in an asset over the fair market value of such asset and would also include amounts for which a tax deduction is permitted in a future period) may be limited.

Premera has obtained a draft tax opinion from E&Y that states that the Conversion Transaction "should" not cause Premera to undergo an "ownership change". A "should" level of opinion provides a relatively high level of assurance. While tax advisors may differ somewhat on the exact level of comfort,

it would not be unreasonable to view a "should" opinion as providing assurance in the 70 to 80 percent range.

Assuming an ownership change does not occur upon the Conversion Transaction, an ownership change could occur subsequently if shares of Premera stock sold by the Foundation or Premera result in a more than 50 percent ownership change during a 3-year period. The Premera divestiture plan combined with potential new stock issuance(s) will give rise to a significant risk that Premera will experience an ownership change following the Conversion Transaction.

While we express no opinion as to whether the Conversion Transaction will result in an "ownership change", we do not believe that Premera's reliance on the E&Y tax opinion in achieving comfort with respect to this issue is unreasonable.

D. Foundation Shareholder/Charitable Organization Tax Issues

A number of tax issues arise in connection with the Foundation Shareholder(s) and Charitable Organizations. A separate report is attached as Exhibit 1 that addresses these issues. We recommend that these issues be fully analysed prior to any final decision on the form and operation of the Foundation Shareholder(s)/Charitable Organization structure.

E. Increase in Alaska Premium Tax Rate

The premium tax rate imposed on Alaska premiums will be increased from the present tax rate of 2 percent to 2.7 percent as a result of the Conversion Transaction.

F. State of Washington Tax Matters

Premera intends to obtain comfort with respect to various Washington State tax matters through a ruling from the Washington Department of Revenue ("DOR"). Premera will request that the Washington Department of Revenue make a determination with respect to the treatment of the Conversion Transaction on the

following: Washington Business & Occupation Tax; the Washington Retail Sales & Use tax; and the Washington Real Estate Excise Tax.

Premera has indicated that a pre-submission conference has been held with representatives of the DOR. Submission of the ruling request has been deferred pending greater certainty regarding the structure of the Conversion Transaction relating to the formation of the Foundation and/or Charitable Organizations. Premera has indicated that it expects to receive the ruling prior to the completion of the Conversion Transaction.

PwC does not find the manner in which Premera obtained comfort with respect to the Washington state tax matters to be unreasonable. PwC does, however, recommend that the OIC consider conditioning approval of the Conversion Transaction on the receipt of a favorable ruling from the DOR on these tax matters.

G. Tax Indemnification

The Indemnification Agreement as it is currently drafted requires, in part, that the Foundation Shareholder indemnify Premera for any and all additional tax obligations that arise as a result of the Conversion Transaction. These potential tax liabilities may be significant.

Under this agreement, the Foundation Shareholder is required to maintain a minimum level of net worth to cover its obligations under the Agreement. While Premera has not yet indicated the level of net worth that would be required to cover potential tax obligations, the potential tax exposure could be significant.

We have concern as to whether the risks passed on to the Foundation(s) as a result of this agreement are appropriate, and suggest that the OIC consider disapproval of the tax indemnification.

H. OIC Approval Conditions for Consideration

We suggest that the OIC consider whether it would be appropriate to condition any approval of the transaction (apart from other considerations) on the following tax items:

1) Timely receipt of final tax opinions acceptable to the OIC on the following tax matters:

   a) the tax-free treatment of the Conversion, both long and short form opinions

   b) the ability of Premera to avoid an ownership change under section 382, and

   c) the ability of Premera to avoid a material change under section 833

2) Receipt of a satisfactory favorable ruling from the state of Washington on the tax treatment of the Conversion that would take into consideration any changes in the facts of the Conversion Transaction from that currently proposed.

3) Certain amendments are made to the Plan of Conversion, as discussed at page 21 of the report.

4) Review and analysis of the tax issues associated with the Foundation Shareholder(s)/Charitable Organization structure prior to any final decision on the form and operation of such.

III. Tax Issues and Observations

The following section provides a more detailed analysis of the significant tax issues identified during the review process and the potential impact of such issues[1].

A. Tax-Free Treatment of the Conversion

Will the Conversion qualify for tax-free treatment?

1. Background

Premera did not request a ruling from the Internal Revenue Service regarding this matter. Rather, Premera intends to rely on tax opinions from E&Y. Premera has received "draft" tax opinions[2] from E&Y that provide, in part, the following:

- The Transactions[3] "will" constitute one or more reorganizations within the meaning Section 368(a) of the Code[4] and the Formation[5] "will" constitute a transaction to which Section 351 applies, and
- No gain or loss will be recognized by the Foundation, Premera, New Premera, PBC, New PBC, PBC Alaska, WAGS, Quality Solutions,

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[1] Additional observations relating to prior year tax matters have been included in a separate accounting due diligence report.

[2] It is our understanding that E&Y will issue a final short-form tax opinion accompanied by a supporting long-form tax opinion to Premera prior to the completion of the Conversion Transaction.

[3] The term Transactions is defined in the tax opinion to include all reorganization steps in the Plan of Conversion accept the formation of the Foundation (Foundation Formation), the Amendment to the Premera Articles of Incorporation (Amendment), and the formation of PBC Alaska (Formation).

[4] All Code references refer to the Internal Revenue Code of 1986, as amended.

[5] The term Formation is defined in the tax opinion as the formation of PBC Alaska whereby PBC contributes all of the assets and liabilities relating to the Alaska health insurance business to PBC Alaska in exchange for all of the stock of PBC Alaska.

New Quality Solutions, LifeWise Washington and New LifeWise Washington as a result of the Conversion[6].

Premera has indicated that the reason the Company decided to obtain a tax opinion as opposed to a private letter ruling (which would generally provide greater certainty with respect to this issue) is based on the Company's understanding that the Internal Revenue Service ("the Service') would require Premera to represent that it would not take the "Special Deduction" (discussed in more detail below) in tax years after the Conversion Transaction is completed[7].

2. PwC Comment

While we express no opinion on the tax-free treatment of the conversion, we do not find the "draft" tax opinions issued by E&Y to be unreasonable. While a favorable private letter ruling would provide certainty with respect to this matter, [PROPRIETARY MATERIAL REDACTED] Consequently, we do not believe that it is unreasonable for Premera to rely on tax opinions of this nature for purposes of obtaining comfort with respect to this issue.

Adequacy of E&Y Tax Opinions. We also note the following matters in connection with the E&Y opinions:

- The tax opinions may not be relied upon by any party other than Premera, including the Foundation(s), and the Charitable

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[6] The term Conversion is defined in the tax opinion to include the Foundation Formation, the Amendment, the Formation, and the Transactions.

[7] It should be noted that the Service has recently issued (January of 2003) a private letter ruling on a similar conversion transaction. This ruling held that the conversion was a tax-free reorganization. The ruling also indicated that the Service expressed no opinion with regard to whether the conversion involved a "material change in structure or operations".

Organizations (and the OIC), not withstanding their involvement in the Conversion.

- The tax opinions are in "draft" form and do not currently incorporate changes requested by PricewaterhouseCoopers and agreed to by Premera and E&Y (See comments below).

B. Possible Loss of Blue Cross and Blue Shield Federal Tax Benefits

Will the Conversion Transaction cause Premera Blue Cross ("PBC") to experience a "material change in structure or operations" resulting in a loss of the "Special Deduction" and other favorable tax benefits?

1. Background

Existing Blue Cross/Blue Shield ("BCBS") organizations were granted certain special tax benefits not available to other taxpayers as a result of the enactment of Code Section 833(b) in 1986. Specifically, existing BCBS organizations:

- Are treated as insurance companies for federal income tax purposes,
- Are entitled to a tax deduction ("special deduction") which can in many cases substantially reduce the taxable income of the BCBS organization,
- Are permitted to adjust ("Step-Up") the tax basis in its assets owned as of January 1, 1987 to their fair market values as of that date, and
- Are excluded from the requirement to reduce the deduction for unearned premium reserves by 20 percent.

In order to qualify for these special tax benefits, a BCBS organization must have been in existence on August 16, 1986, such organization must have been determined to be exempt from tax for its last taxable year

beginning before January 1, 1987, and the organization must not have experienced a **"material change in structure or operations"** after August 16, 1986 and before the close of the taxable year.

[Proprietary Material
Redacted]

A "material change in structure" is not defined in the Code or Treasury Regulations. The Committee Reports to the Tax Reform Act of 1986 provide examples of certain transactions that will *not* constitute a "material change in structure".[8]

There is no guidance, however, that specifically addresses whether a "material change in structure" occurs when an existing BCBS organization converts from a non-profit, non-stock entity to a for-profit, stock entity.

[Proprietary Material
Redacted]

[8] Such examples would include the merger of two existing BCBS organizations, or the acquisition by an existing BCBS organization of a healthcare related business are described in the Committee Reports as transactions that will not constitute a "material change in structure".

[Proprietary Material
Redacted]

Premera currently has established a valuation allowance against its tax attributes including net operating loss carryovers and alternative minimum tax credits. Its federal effective tax rate in previous years has approximated 20 percent[9] as a result of reflecting the benefit of the "Special Deduction" in its financial statements.

[Proprietary Material
Redacted]

[9] Generally, it can be expected that the effective tax rate should approximate the Alternative Minimum Tax Rate of 20 percent as a result of the "Special Deduction". However, Premera's actual effective rate does vary slightly from year to year due to other permanent tax items. In 2002, for example, the effective tax rate was 27.5 percent, approximately 4 percent higher than in previous years, due to the inclusion of state income taxes not included in previous years.

[Proprietary Material
Redacted]

2. **Tax Impact if it is Determined that Premera Does Experience a "Material Change in Structure or Operations" as a Result of the Conversion Transaction**

If it were determined that Premera experiences a "material change in structure or operations" as a result of the Conversion Transaction, based on projected financial results, the tax liability of Premera would likely increase significantly in future periods as a result of:

- The loss of the "special deduction,[10]

[Proprietary Material
Redacted]

- The requirement to subject its unearned premium reserve to the 20 percent haircut.

Premera has indicated that Premera Blue Cross will continue to qualify as an insurance company even if the "deemed" insurance company status is lost. PwC requested, and was provided with an analysis supporting this position. Based on our review of this analysis and our understanding of the Company's operations, we do not believe that the Company's position is unreasonable.

[Proprietary Material
Redacted]

3. **Financial Statement Impact if Premera is Determined to Experience a "Material Change in Structure or Operations"**

Based on an analysis provided by Premera, if the special tax benefits described above were lost as a result of the Conversion Transaction, the following financial reporting consequences would occur:

- The valuation allowance established against the net operating loss carryovers, AMT credit carryovers, and other deferred tax items will be released,
- The federal effective tax rate will increase from the current rate of approximately 20 percent to approximately 35 percent in future reporting periods, and
- The tax paid to the Internal Revenue Service ("Cash Tax") will increase beginning in 2007, based on projections provided by Premera[12]

4. **PwC Comments**

As mentioned, PricewaterhouseCoopers requested, but was not provided with a detailed and well-reasoned analysis supporting the [PROPRIETARY MATERIAL REDACTED] tax opinion issued by E&Y and is therefore not in a position to fully assess whether a [Proprietary Material Redacted] level of assurance is reasonable.

This is an unsettled area of tax law and the Internal Revenue Service has not taken an official, public position on the issue of whether a conversion transaction causes a "material change in structure". However, in informal discussions, Internal Revenue Service representatives have indicated that

[PROPRIETARY MATERIAL REDACTED]

they generally view a conversion transaction such as that proposed by Premera as causing a "material change in structure" thus resulting in the loss of the Section 833(b) special tax deduction, and other possible detriments.

We believe there are arguments that could be made to support the position that the Conversion Transaction should not cause Premera to experience a "material change in structure". However, there is considerable uncertainty surrounding this issue given the lack of direct authority and the IRS' view on this matter. Accordingly, the risk of Premera experiencing a "material change in structure", and attendant loss of tax benefits, is significant and must be considered by the OIC in evaluating the potential negative financial impact to the company, policyholders, and public as a result of the Conversion Transaction.

The OIC should also consider whether it is comfortable with the Company's assertion that any adverse tax consequences that may result from a loss of the special tax benefits will not be passed on to policyholders.

Financial Reporting and Disclosure by Other Converted Blue Plans. Based on our review and analysis of public documents (including Forms S-1 and 10-K) filed by other Blue Cross and Blue Shield Plans that have completed similar Conversion Transactions, we have found that the tax accounting treatment and extent of disclosure in connection with the loss of the "Special Deduction" and other tax benefits often varies from that proposed by Premera.

Of the Companies surveyed, it appears that most of the Companies did not continue to reflect the benefit of the "Special Deduction" in their financial statements after the Conversion Transaction. While the Companies surveyed all have varied and unique facts and circumstances, it was our

general observation that most companies released the valuation allowance in the year of the Conversion Transaction (which creates an unusually low effective tax rate in the year of the conversion) and subsequently increased the effective tax rate to approximately 35 percent in post-conversion periods. Additionally, these companies provided extensive disclosure of the risk of loss of the "Special Deduction" and other tax benefits in the Risk Factors, MD&A, and financial statement footnotes.

Adequacy of E&Y Tax Opinion. We also note the following matters in connection with the E&Y tax opinion:

- The tax opinion may not be relied upon by any party other than Premera including the OIC, the Foundation(s), and the Charitable Organizations,
- The tax opinion does not provide a well-reasoned legal analysis in support of the tax opinion, and
- The tax opinion is in "Draft" form (See comments below).

C. Restrictions of Tax Attributes Under Section 382 of the Code

Whether the Conversion or subsequent sale of New Premera stock (by Foundation and/or IPO) will cause the tax attributes of Premera to be restricted under Section 382 of the Code.

1. Background

If it is determined that the Conversion Transaction or a subsequent stock sale results in an "ownership change", future utilization of tax attributes such as net operating loss carryovers, alternative minimum tax credit carryovers, and built-in losses may be limited. An ownership change is generally defined as a more than 50 percent shift in the ownership of stock in a corporation over a period of 3 years. When an ownership change

occurs, the annual utilization of tax attributes, as described above, is generally limited to the value of the corporation multiplied by the long-term tax-exempt rate.

Premera has obtained a draft tax opinion[13] from E&Y that states that the Conversion Transaction **"should"** not cause Premera to undergo an "ownership change" as the term is defined in Section 382(g) of the Code. A "should" level of opinion provides a relatively high level of assurance. While tax advisors may differ somewhat on the exact level of comfort, it would not be unreasonable to view a "should" opinion as providing assurance in the 70 to 80 percent range.

The E&Y tax opinion relates solely to the Conversion Transaction and does not address whether an ownership change occurs upon the issuance of stock in an IPO or upon the sale of Premera stock by the Foundation. Premera is unwilling to expand the tax opinion to include a subsequent sale of stock (through IPO or by the Foundation).

Premera has provided an analysis indicating that the annual limitation on the utilization of tax attributes would approximate $[ ] million based on an estimate of the current fair market value of Premera. As a result of the Blue Cross Blue Shield Divestiture Agreement, Premera expects to experience an ownership change beginning in 2007. Assuming an ownership change does not occur upon the Conversion Transaction, an ownership change could occur prior to 2007 if shares of Premera stock sold by the Foundation or Premera result in a more than 50 percent ownership change.

PROPRIETARY MATERIAL REDACTED

Based on projections provided by Premera, it does not appear that an "ownership change" under Section 382, by itself, would cause Premera to

[13] The draft long-form tax opinion addresses both the tax-free treatment of the Conversion Transaction and the ownership change under Section 382.

have tax attributes expire unutilised. The timing of the utilization of the tax attributes would be impacted, however, the effect may not be material.

Premera has indicated that it may consider placing certain restrictions on the Foundation Shareholder's ability to sell the Premera stock to avoid a Section 382 limitation. However, given the significance of this issue, it does not appear that any such restrictions are warranted.

2. PwC Comments

We do not believe that Premera's reliance on the E&Y tax opinion in achieving comfort with respect to this issue is unreasonable.

Adequacy of E&Y opinion. We also note the following matters in connection with the E&Y tax opinion:

- The tax opinion may not be relied upon by any party other than Premera including the OIC, the Foundation(s), and the Charitable Organizations,
- The tax opinion does not address whether an ownership change occurs as a result of an IPO or sale of stock by the Foundation Shareholder, and
- The tax opinion is in draft form.

D. Foundation Shareholder/Charitable Organization Tax Issues

A number of tax issues arise in connection with the Foundation Shareholder(s) and Charitable Organizations. A separate report is attached as Exhibit 1 addressing these issues. We recommend that these issues be fully analysed prior to any final decision on the form and operation of the Foundation Shareholder(s)/Charitable Organization structure.

E. Increase in Alaska Premium Tax Rate

The premium tax rate imposed on Alaska premiums will be increased from the present tax rate of 2 percent to 2.7 percent as a result of the Conversion Transaction.

F. State of Washington Tax Matters

1. Background

Premera intends to obtain comfort with respect to various Washington State tax matters through a ruling from the Washington Department of Revenue ("DOR"). Premera will request that the Washington Department of Revenue make a determination with respect to the treatment of the Conversion Transaction on the following: Washington Business & Occupation Tax; the Washington Retail Sales & Use tax; and the Washington Real Estate Excise Tax.

Premera has indicated that a presubmission conference has been held with representatives of the DOR. Submission of the ruling request has been deferred pending greater certainty regarding the structure of the Conversion Transaction relating to the formation of the Foundation and/or Charitable Organizations. Premera has indicated that it expects to receive the ruling prior to the completion of the Conversion Transaction.

2. PwC Comments

PwC does not find the manner in which Premera obtained comfort with respect to the Washington state tax matters to be unreasonable. PwC does, however, recommend that the OIC consider conditioning approval of the Conversion Transaction on the receipt of a favorable ruling from the DOR on these tax matters.

G. Tax Indemnification

1. Background

The Indemnification Agreement as it is currently drafted requires, in part, that the Foundation Shareholder indemnify Premera for any and all additional tax obligations that arise as a result of the Conversion Transaction. These potential tax liabilities may include, but are not limited to the following:

- Additional tax resulting from the loss of the Special Deduction and other special benefits under Section 833(b) in the year of the transaction as well as in all subsequent years in which Premera would have been entitled to the Section 833(b) benefits, but for the Conversion Transaction;
- Additional tax resulting from the inability to utilize tax attributes such as net operating loss carryovers and alternative minimum tax credits to the extent such attributes are limited as a result of the Conversion Transaction; and
- Additional tax resulting from the Conversion Transaction not being treated as a series of tax-free transactions.

Under this agreement, the Foundation Shareholder is required to maintain a minimum level of net worth to cover its obligations under the agreement. While Premera has not yet indicated the level of net worth that would be required to cover potential tax obligations, the potential tax exposure could be significant.

2. PwC Comments

We have significant concern whether the risks passed on to the Foundation(s) as a result of the tax indemnification agreement are appropriate, and suggest that the OIC consider disapproval of the tax indemnification.

As discussed above, the E&Y tax opinions may not be relied upon by any party other than Premera. Therefore, if the Tax Indemnification agreement is ultimately approved, we would strongly recommend that the Foundation either obtain its own tax opinion(s) from an outside advisor or require that the E&Y opinions be modified to allow the Foundation Shareholder to rely upon them.

H. OIC Approval Conditions for Consideration

We suggest that the OIC consider whether it would be appropriate to condition their approval of the transaction (apart from other considerations) on the following tax items:

1) Timely receipt of final tax opinions acceptable to the OIC on the following tax matters:

   a) the tax-free treatment of the Conversion, both long and short form opinions

   b) the ability of Premera to avoid an ownership change under section 382, and

   c) the ability of Premera to avoid a material change under section 833

2) Receipt of a satisfactory favorable ruling from the state of Washington on the tax treatment of the Conversion that would take into consideration any

changes in the facts of the Conversion Transaction from that currently proposed.

3) Amendments to the Plan of Conversion as follows:

   a) Article IV, Section 4.3(a)(xiv) of the current draft of the Plan of Conversion provides for an IRS ruling that we understand to be inconsistent with the current plans of Premera. Accordingly, changes would seem necessary to this section.

   b) Section 4.3(a)(xv) contains a provision which allows Premera to unilaterally waive certain conditions including the condition requiring Premera to obtain a tax opinion on the effects of the Conversion Transaction. We believe this waiver should be eliminated from the Plan of Conversion.

4) Review and analysis of the tax issues associated with the Foundation Shareholder(s)/Charitable Organization structure prior to any final decision on the form and operation of such.

IV. Caveats and Limitations

The aforementioned analyses of historical and prospective information contained in our report were based upon certain procedures approved by the OIC and performed by PricewaterhouseCoopers. The OIC is responsible for the sufficiency of the procedures as well as for drawing conclusions with respect to PwC's findings.

We make no representation regarding the sufficiency of our work either for purposes for which this report has been requested or for any other purpose. The sufficiency of the work we performed is solely the responsibility of the OIC, as are any decisions with respect to the proposed transaction. Had we been requested to perform additional work, additional matters might have come to our attention that would have been reported to you.

It is understood that this report is solely for the information of the OIC. PricewaterhouseCoopers' findings may be included in whole or in part in the record upon which any regulatory determination may be made by the OIC, which PricewaterhouseCoopers understands may be a matter of public record. If the OIC chooses to name PricewaterhouseCoopers in any report, the OIC should disclose that PricewaterhouseCoopers is not responsible for the sufficiency of the procedures for the purpose of the OIC's evaluation of the proposed transaction. PricewaterhouseCoopers' report will be intended solely for the information and use of the OIC and is not intended to be and should not be used by anyone else.

In addition to the foregoing, this report, or portions thereof, is not to be referred to or quoted, in whole or in part, in any registration statement, prospectus, public filing, loan agreement, or other agreement or document without our prior written approval, which may require that we perform additional work.

EXHIBIT 1

Report on Tax Matters in Connection with the Foundation Shareholder(s) and Charitable Organizations

PRICEWATERHOUSECOOPERS

PREMERA

Exhibit 1

Report on Tax Matters in Connection with The Foundation Shareholder(s) and Charitable Organizations

Prepared for the Washington Office of the Insurance Commissioner

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PREMERA CONVERSION TRANSACTION

Re: Considerations Regarding the Tax Status of the Entity (or Entities) to be Utilized to Accept and Sell the Shares of New Premera and To Invest and Deploy the Proceeds for the Healthcare Needs of the Citizens of the States of Washington and Alaska

I. EXECUTIVE SUMMARY

A. Premera Proposal

Consistent with the historic nonprofit purpose of many health plans, and to avoid the expense of potentially significant federal income taxes, it has become the custom of the parties to "Blues Conversion" type transactions to form an entity (or entities) designated to accept, manage, and deploy the resulting funds to benefit public healthcare organizations that are exempt from federal income tax. The Premera Conversion Transaction Plan (the "Plan") also proposes the formation and use of three such entities, each intended to qualify for federal income tax exemption. One organization (the "Foundation Shareholder") is intended to qualify for exemption as a "social welfare organization" described in Code section 501(c)(4)*. It would have at least two roles. First, it would accept contributions of cash (or other property) from Premera (or New Premera) which would be earmarked to be used to accomplish objectives and purposes consistent with the purposes set forth in its Articles of Incorporation. This would include the ability, as set forth in its proposed Articles of Incorporation, to devote more than an insubstantial part of its activities to attempting to influence legislation, so long as such legislation promotes the efficient use of health care resources by simplifying and reducing the administrative burdens of health care providers and insurers in Washington and Alaska (PwC is not suggesting that these specific purposes are in the public interest). It's other role would be to accept the New Premera Shares, sell them (consistent with maximizing their potential value) and

* All Code or section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

distribute the resulting net proceeds to a "Washington Charitable Trust" and an "Alaska Charitable Trust", each of which is intended to qualify as a "charitable private foundation" described in section 501(c)(3) (the "Charitable Trusts"). It is intended that the Washington Charitable Trust would receive, hold and deploy the State of Washington's share of the Conversion proceeds. Similarly, The Alaska Charitable Trust is intended to receive, hold and deploy Alaska's share of the Conversion proceeds.

It is important to note that it is believed that the gain from the sale of the New Premera Shares will be approximately equal to the net proceeds from such sale. Unless the entity that sells the Shares is exempt from federal income tax, such gain will be subject to federal income tax at a rate as high as 35%.

Inherent in the Plan as it relates to the formation and use of these federally tax-exempt organizations are certain intended advantages and related disadvantages. Specifically, the significant advantages of the Plan as proposed would be:

1. No federal income tax would be incurred upon the receipt of the New Premera Shares from Premera by Foundation Shareholder, the entity to be established for the purpose of facilitating the liquidation of such Shares;

2. No federal income tax would be incurred on the gain from the sale by Foundation Shareholder of the New Premera Shares;

3. No federal income tax would be incurred by Foundation Shareholder on the income earned by investing the net proceeds derived from the sale of the New Premera Shares;

4. No federal income tax would be incurred upon either the distribution by the Foundation Shareholder of the net proceeds from the sale of the New Premera Shares and any earnings thereon or the receipt by the charitable trusts (the Washington Charitable Trust and the Alaska Charitable Trust) of such proceeds and earnings;

5. Finally, and most significantly, it is intended that no federal excise tax (generally imposed on private foundations at the rate of 2% on the "net investment income," including capital gains, but not on social welfare organizations) would be imposed on the gain from the sale by Foundation Shareholder of the New Premera Shares. (Nor is it expected that Foundation Shareholder and certain related parties would be required to comply with certain other restrictions and requirements, including mandatory grant making minimum distributions before there would be cash available for such purposes from the sale of the New Premera Shares.)

The significant disadvantages that could or would result from the implementation of the Premera Conversion Transaction Plan as it relates to the formation and use of the three exempt organizations are as follows:

1. If a reasonable degree of tax certainty is an objective to be achieved it may be necessary to delay the distribution of the New Premera Shares to the Foundation Shareholder until the IRS recognizes that the Foundation Shareholder is exempt from federal income tax by reason of being described in Code section 501(c)(4). This could take as few as three months to as many as twelve months or longer from the time that the Foundation Shareholder is formed, partially funded and applies for recognition of its intended federal tax status. The most likely reason why the IRS would decline to recognize the Foundation Shareholder as an organization described in Code section 501(c)(4) would be the IRS conclusion that the primary purpose of the Foundation Shareholder is to act as an intermediary with respect to the New Premera Shares, notwithstanding the fact that it will also engage in activities consistent with promoting the welfare of the citizens of the States of Washington and Alaska.

2. From an exempt organization perspective, the Plan is complex. The formation, maintenance and operation of the three exempt organizations that would be created by the Plan would require significant coordination and resources. Moreover, it may be difficult to provide clear and understandable explanations for the reasons the organizations exist, the relationship between and among the three organizations and, the differences in the tax requirements to maintain each.

B. Alternatives

Although a number of "Blues Conversion" type transactions have occurred in the past 10 years, no pattern of "best practices" from a tax-perspective appears to have surfaced as such transactions relate to establishing one or more organizations to hold and deploy, for the benefit of the public, the value of funds created upon the sale of these nonprofit insurance businesses.

Most foundations established as a result of healthcare conversion transactions are private foundations and a few are recognized as social welfare organizations. The following chart, "A Profile of New Health Foundations" details the tax-exempt status of recent health plan conversion organizations.

A PROFILE OF NEW HEALTH FOUNDATIONS
HEALTH PLAN CONVERSIONS

State, Name, and Web Address	Year of Conversion	Current Assets 2001	IRS Tax-Exempt Status	Grant Making Focus
CALIFORNIA				
The California Endowment Woodland Hills, CA www.calendow.org	1996	$2,887,000,000	Private Foundation 501 (c)(3)	Access to health and related services for underserved individuals and communities; improvements in health status; cultural competency; health disparities; workforce diversity
California HealthCare Foundation Oakland, CA www.chcf.org	1996	$723,000,000	Social Welfare Organization 501 (c)(4)*	Health care delivery; business practices in health care; health policy
Alliance Healthcare Foundation San Diego, CA www.alliancehf.org	1994	$74,000,000	Private Foundation 501 (c)(3)	Access; substance abuse; communicable disease; violence prevention; mental health services; environmental and community health
The California Wellness Foundation Woodland Hills, CA www.tcwf.org	1992	$985,910,600	Private Foundation 501 (c)(3)	Diversity in health professions; environmental health, healthy aging; womens' health; mental health; teen pregnancy prevention; violence prevention, work and health
COLORADO				
Caring for Colorado Foundation Denver, CO www.caringforcolorado.org	1999	$130,000,000	Social Welfare Organization* 501 (c)(4)	Infrastructure; emerging community issues; enabling informed health decisions
CONNECTICUT				
Connecticut Health Foundation Farmington, CT www.cthealth.org	2001	$130,000,000	Private Foundation 501 (c)(3)**	Oral health; children's mental health; racial and ethnic health disparities
Anthem Foundation of Connecticut West Hartford, CT www.anthemfdnct.org	1999	$44,000,000	Pubic Charity 509 (a)(3) supporting organization	Health care financing; quality care/compliance; community empowerment

State, Name, and Web Address	Year of Conversion	Current Assets 2001	IRS Tax-Exempt Status	Grant Making Focus
DISTRICT OF COLUMBIA				
Consumer Health Foundation Washington, DC www.consumerhealthfdn.org	1994	$31,013,487	Private Foundation 501(c)(3)	Health status improvement; consumer involvement in their own health; access to health care, including primary care, prevention, health promotion, and AIDS services; capacity building; vulnerable populations; health disparities.
GEORGIA				
Healthcare Georgia Foundation Atlanta, GA. www.healthcaregeorgia.org	1999	$117,000,000	Private Foundation 501(c)(3)	Health disparities; organizational improvement of health-related nonprofit organizations; access to primary care
KANSAS				
The Sunflower Foundation Topeka, KA www.sunflowerfoundation.org	2000	$79,000,000	Public Charity 509 (a)(3) supporting organization	Access to health care (health insurance, safety net, workforce); disease prevention and health promotion (obesity, tobacco use); aging (access to prescription drugs for low-income elderly, caregiving, resident-directed care); and mental health
KENTUCKY				
Foundation for a Healthy Kentucky Louisville, KY www.healthyky.org	2001	$46,500,000	Public Charity 509 (a) (1) traditional	Health education and prevention focused on children and families; access to health care and services
MAINE				
Maine Health Access Foundation, Inc. Augusta, ME www.mehaf.org	2000	$81,000,000	Private Foundation 501(c)(3)	Affordable and timely access to comprehensive quality health care; strategic solutions to health care needs, particularly for the medically uninsured and underserved.

State, Name, and Web Address	Year of Conversion	Current Assets 2001	IRS Tax-Exempt Status	Grant Making Focus
MASSACHUSETTS				
The Health Foundation of Central Massachusetts, Inc. Worcester, MA www.hfcm.org	1995	$47,000,000	Social Welfare Organization* 501 (c)(4)	Oral health; mental health; child abuse treatment and prevention
MISSOURI				
The Missouri Foundation for Health St. Louis, MO www.mffh.org	2000	$830,000,000	Social Welfare Organization* 501 (c)(4)	Improving health and filling gaps in health services
NEW HAMPSHIRE				
Endowment for Health, Inc. Concord, NH www.endowmentforhealth.org	1999	$71,500,000	Private Foundation 501 (c)(3)	Oral health; economic, geographic, and social/cultural barriers to accessing health and health care
Healthy New Hampshire Foundation Concord, NH	1997	$13,500,000	Private Foundation 501 (c)(3)	Health insurance coverage; health promotion
NEW MEXICO				
Con Alma Health Foundation Santa Fe, NM www.conalma.org	2001	$15,000,000	Private Foundation 501(c)(3)	Health and health-related projects
NEW YORK				
Community Health Foundation of Western New York and Central New York Buffalo, NY	2001	$45,000,000	Private Foundation 501(c)(3)	Access; improved quality; underserved populations; the uninsured; children; elderly

State, Name, and Web Address	Year of Conversion	Current Assets 2001	IRS Tax-Exempt Status	Grant Making Focus
OHIO				
The Health Foundation of Greater Cincinnati Cincinnati, OH www.healthfoundation.org	1997	$260,000,000	Social Welfare Organization 501 (c)(4)	Strengthening primary care providers to the poor; school-based child health interventions; substance abuse; severe mental illness
The Anthem Foundation of Ohio Cincinnati, OH www.greatercincinnatifdn.org	1995	$26,882,000	Public Charity 509 (a)(3) supporting organization	Preventive oral health care; family violence prevention programs for indigent populations
Columbus Medical Association Foundation Columbus, OH www.cmaf-ohio.org/cmaf	1992	$70,000,000	Public Charity 509 (a)(1) traditional	Access to health care; health education; health promotion
OREGON				
Community Health Partnership Portland, OR www.community.oregonlive.com	1997	$1,562,000	Public Charity 509 (a) (3) Supporting Organization	Public health; graduate scholarships; public health workforce development; urgent needs in public health system
Northwest Health Foundation Portland, OR www.nwhf.org	1997	$65,000,000	Social Welfare Organization 501 (c)(4)*	Rural health; access; mental health; children; youth; disease-related projects

* These 501 (c)(4) organizations, often under pressure from consumer groups concerned about governance, accountability and transparency and sometimes pursuant to state statute, have adopted by-laws containing 501 (c)(3) private foundation restrictions, such as prohibition against private inurement and self-dealing transactions, prohibitions on certain types of loans, and minimum payout requirements (although some permit the board in certain circumstances (e.g. bear markets) to make qualifying distributions that are less than the approximately five percent of endowment required of 501 (c)(3) private foundations. The Health Foundation of Central Massachusetts initially incorporated as a 501 (c)(3) but changed to a 501 (c)(4) with restrictions in order to gain greater flexibility in pursuing public policy goals.

** This 501 (c)(3) private foundation was originally incorporated as a 501 (c)(4) social welfare organization with by-laws incorporating 501 (c)(3) restrictions. In July 2002, it incorporated as a 501 (c)(3), as required by the state attorney general.

PRE-1992 HEALTH FOUNDATIONS HEALTH PLAN CONVERSIONS

State, Name, and Web Address	Year of Conversion	Current Assets 2001	IRS Tax-Exempt Status	Grant making Focus
Michael Reese Health Trust Chicago, IL www.fdncenter.org/grantmaker/health	1991	$80,178,543	Private Foundation 501 (c)(3)	Health care; health education; limited health research, primarily for public policy and advocacy
Prime Health Foundation Kansas City, MO www.primehealthfoundation.org	1989	$7,000,000	Private Foundation 501 (c)(3)	Managed care; health care education; disease management
Archstone Foundation Long Beach, CA www.archstone.org	1985	$105,802,818	Private Foundation 501 (c)(3)	Health and well-being of the elderly and their caregivers
Greater St. Louis Health Foundation St. Louis, MO	1985	$4,200,000	Private Foundation 501(c)(3)	Health care providers; health promotion and illness prevention; seed money for new projects
Georgia Health Foundation Atlanta, GA www.gahealthfdn.org	1985	$7,500,000	Private Foundation 501 (c)(3)	Access; service delivery; health maintenance; public awareness; education; quality; evaluation; clinical research; preventive care
The Health Foundation of Greater Indianapolis, Inc. Indianapolis, IN www.thfgi.org	1984	$25,573,540	Private Foundation 501 (c)(3)	HIV/AIDS (advocacy, prevention); adolescent/child health (access to primary care, school-based health); elder health (advocacy)
Sierra Health Foundation Sacramento, CA www.sierrahealth.org	1984	$125,000,000	Private Foundation	Capacity building; children's health; other health-related programs

The data in these charts is compiled from a May 2003 report published by Grantmakers in Health, A Profile of New Health Foundations, and from interviews with health foundation executives.

At least three models to minimize potential federal tax liabilities associated with the sale of the New Premera Shares and investment of the proceeds deserve consideration:

1. The Current Two-Tier Plan: The proposed Premera Plan would utilize the Foundation Shareholder to avoid the imposition of a private foundation excise tax (at the rate of as much as 2%) on the gain from the sale of the New Premera Shares. It could also use the Foundation Shareholder to achieve certain objectives and purposes consistent with promoting the welfare of the citizens of the States of Washington and Alaska, if the lobbying purposes were appropriately defined. In addition, it may also assist with the coordination of the interests of Washington and Alaska in the Shares until and in connection with their sale. Ultimately, Washington's share of the proceeds from the sale of the New Premera Shares would pass to the Washington Charitable Trust, an organization that for federal income tax purposes would be classified as a "charitable private foundation." (As such, its net investment income would be subject to an excise tax, at the rate of as much as 2%; it would be required to distribute annually in grants (and certain other "qualifying distributions") no less than 5% of the prior year's value of its assets; and, there also would be some restrictions on its grant making ability.) Correspondingly, in order to obtain and retain its exemption from federal income tax as a charitable private foundation its governing instruments would need to make it clear that it could not and would not engage in or fund, directly or indirectly, any activities constituting campaigning for or against a candidate running for public office or lobbying a legislative body to do anything other than something that is non-partisan and/or that would directly affect the trust itself.

2. Section 501(c)(4) Social Welfare Organization Only: Alternatively, were the Washington Trust (and, also presumably the Alaska Charitable Trust)

organized to qualify as a tax exempt "social welfare organization" (as opposed to a "charitable private foundation") there would be no foundation excise tax on the sale of the New Premera Shares to the public (as well as on any investment income earned on the sale proceeds); nor a 5% mandatory minimum distribution requirement; nor any of the referenced grant making restrictions.

This model would have the additional benefit of promoting simplicity by eliminating the need for tax purposes (and perhaps altogether) to form and maintain any other tax exempt organizations.

There are several possible disadvantages to this model (which may also apply to the section 501(c)(4) Foundation Shareholder in the two-tier Premera Plan). First, it may not be prudent or possible to organize a social welfare organization to significantly limit its ability to engage in political campaign and lobbying activities. (This is because this is one of the principal differences for tax purposes between a "charitable" organization and a "social welfare" organization.) Thus, if the governing instruments of an organization like the Foundation Shareholder contain certain Code section 501(c)(3) restrictions, it is less likely that the IRS will recognize such organization as a Code section 501(c)(4) entity. This is the case, even though, as the chart profiling healthcare conversion foundations shows, some states have formed social welfare organizations with by-laws containing section 501(c)(3) restrictions. Second, the resulting organization may not qualify to receive grants that may otherwise be available under certain federal government programs and/or the guidelines of certain large independent private foundations.

3. Section 501(c)(3) Private Foundation Only: If it is determined that the organization to ultimately hold and deploy the funds created from the sale of the New Premera Shares should be a "charitable" organization for

federal income tax purposes, consideration should be given to eliminating the role of the Foundation Shareholder and establishing only "charitable" organizations like the contemplated Washington Charitable Trust under the Plan. This would have the benefit of avoiding the cost and complexity of utilizing an additional organization. It would also result in greater, if not perfect, ability to forecast and to explain to the public the total tax costs and responsibilities of the structure that is to be adopted. Obviously, the significant disadvantage of this alternative is the fact that it would result in the imposition of a private foundation excise tax (at a rate of as much as 2%) on the gain from the sale of the New Premera Shares.

There follows a more detailed explanation and analysis of the considerations addressed in this executive summary, as well as some additional issues not relevant to an overview.

II. OVERVIEW OF THE INTERNAL REVENUE CODE REGULATION OF TAX-EXEMPT ORGANIZATIONS

Dozens of different types of tax-exempt organizations exist. The foundations and other entities that receive assets from the conversion of a non-profit healthcare organization can operate under several different tax status categories. The type of tax status permitted or recognized by the IRS will not only reflect the purpose and activities of the organization but will affect its governance, operations, and reporting requirements, both directly and indirectly.

Section 501(a) of the Internal Revenue Code confers exemption from income tax on a wide variety of entities. By far the most prevalent type of exempt organizations are the charitable organizations described in section 501(c)(3), such as private foundations and public charities, which are eligible to receive tax deductible contributions. The next most common are social welfare organizations which, although tax-exempt, are much more limited in their eligibility to receive tax-deductible contributions.

The Code does not treat tax-exempt organizations uniformly; for example, it imposes varying prohibitions against self-dealing and political campaign activities, and different degrees of limitation on lobbying, depending on the exempt organization's classification as a private foundation, public charity or social welfare organization. Nor are tax-exempt organizations divided, as under state law, according to the organizational nature of the entity--trust, corporation or unincorporated organization. Instead, they are categorized not only on the basis of their purposes and activities, but also according to the sources of their financial support.

A tax-exempt entity may be a section 501(c)(3) private foundation (with an endowment from a single source and many organizational and operational restrictions) or a public charity (with funding from the general public and fewer restrictions) or a section 501(c)(4) social welfare organization. To justify the privilege of receiving tax-exempt status, the Code requires that all three types:

- must serve a public rather than a private purpose;
- must not be operated for the private or personal benefit of designated individuals or the founders; and
- must engage primarily in activities that further the chosen charitable or exempt purpose.

III. SECTION 501(C)(3) CHARITABLE ORGANIZATIONS

A. Basic Requirements for Exemption

Definition. Section 501(c)(3) entitles entities organized exclusively for religious, charitable, scientific, testing for public safety, literacy or educational purposes to be exempt from most federal taxes. (The enumerated public purposes also include fostering national or international amateur sports competition or preventing cruelty to children or animals.) Many states, honoring this designation, confer similar exemptions for state and local taxes.

To obtain tax-exempt status, section 501(c)(3) requires that:

1. an organization be both organized and operated exclusively to further a proper exempt purpose;

2. no part of the net earnings of the organization inures to the benefit of any private shareholder or individual;

3. no substantial part of the organization's activities consists of carrying on propaganda or otherwise attempting to influence legislation, or participating or intervening in any political campaign on behalf of or in opposition to any candidate for public office; and

4. the organization operates as a common-law charity.

The regulations interpret the Code provision requiring that a charity be organized "exclusively" for exempt purposes to mean "primarily" (Treas. Reg. 1.501(c)(3)-1(c)(1)). The promotion of health is considered to be a charitable purpose.

Requirements in the Organizing Documents. The practice among the majority of those who establish exempt organizations is to track the language in the Code and regulations in order to avoid controversy with revenue agents as to whether the organization will be eligible for exemption. To satisfy the organizational test

under section 501(c)(3), properly drafted organizing documents should include the following:

1. A purpose clause, which limits the purposes of the organization to one or more exempt purposes described in section 501(c)(3);

2. A power clause, which limits the organization's activities to those that further its exempt purposes;*

3. A provision prohibiting private inurement and limiting private benefit;**

4. A dissolution clause, which dedicates the organization's assets solely to exempt purposes and ensures that on dissolution of the organization any remaining assets will be distributed for one or more exempt purposes or to one or more section 501(c)(3) exempt organizations or the federal or state government;

5. A provision prohibiting participation or intervention in a political campaign;

6. A provision limiting lobbying activity; and

7. Provisions relating to private foundation status and private foundation activity limitations.

Each of these clauses relates to a specific element of the organization's operation.

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* The test will not be met if more than an insubstantial part of an organization's activities are not in furtherance of an exempt purpose. Exemption will be denied if the organization's governing documents include a provision expressly permitting it to engage in an activity that does not further its exempt purpose if the activity is more than an insubstantial part of operations.

** The proscription against private inurement applies to benefits that accrue only to "insiders", to persons who have an interest in the organization, such as directors, officers or employees. It applies only when the benefits conferred are not commensurate with the services provided. Thus, it is not an absolute ban on self-dealing, but a standard based or reasonableness which can be substantiated by reference to the terms of an arms-length transaction. The sanction for the violation of the private inurement prohibition is loss of exemption.

With respect to fiduciary duties, the Service objects to inclusion of broad exculpatory clauses on the grounds that they could excuse a trustee from any violations of the conditions for exemption.

The Operational Test. The operational test ensures that the determination of exemption will not be made solely on the basis of an organization's governing documents, but will require a showing that its on-going activities will meet and maintain the conditions for exemption. The hurdle of qualifying as a section 501(c)(3) organization must be met before an organization ever reaches the question of whether it is a public charity or private foundation.

B. Classification as a Private Foundation or Public Charity

The Code presumes a section 501(c)(3) charitable organization is a private foundation, unless it can demonstrate otherwise. Section 509(a) defines a private foundation by exclusion. The term "private foundation" is defined as any organization described in section 501(c)(3) other than the four categories of public charities excepted from private foundation status under section 509. In so doing, the Code divides tax-exempt section 501(c)(3) organizations into two basic classifications: private foundations and public charities.

Public charities include:

1. organizations conducting certain types of legislatively favored activities, such as churches, education (high schools, colleges or universities), hospitals or medical research organizations;

2. certain "publicly supported" organizations receiving a substantial amount of their support from the conduct of exempt function activities and gifts, grants and contributions from the general public or from governmental entities;

3. "supporting organizations" of other public charities excluded from private foundation treatment due to their exclusive operation for the benefit of, to perform the functions of or to carry out the purposes of one or more specified organizations that are not themselves private foundations; and

4. organizations whose exclusive function is testing for public safety.

Private Foundation Requirements. Private foundations, usually endowed from a single source, generally do not engage in operating charitable programs directly but instead make grants to other eligible non-profit organizations. They do not raise funds from the public. To qualify for exemption, a private foundation must provide in its governing instrument special provisions (in addition to those generally required of all section 501(c)(3) organizations under the organizational test) to the effect that it will at all times make distributions; avoid certain dealings with the trustees, officers, and other so-called disqualified persons; and avoid certain investments, in each case, as required by rules mandated by Chapter 42 of the Code.*

Public Charities. By contrast, section 501(c)(3) charities that escape classification as a private foundation are subject to far fewer tax rules and less onerous annual tax reporting requirements.

Classification of the Charitable Trusts as Private Foundations. It is likely that the Washington Charitable Trust and the Alaska Charitable Trust will be classified as private foundations, not public charities because neither would appear to satisfy

* A private foundation's governing instrument is its articles of incorporation, not its bylaws, if it is a corporation; the trust instrument or agreement if it is a trust; and the articles of association if it is an unincorporated association. A private foundation will not qualify for exemption unless its governing instrument includes provisions that require the private foundation to comply with the minimum distribution requirements of section 4942 and that prohibit the private foundation from violating the other provisions of Chapter 42 relating to self-dealing (section 4941), excess business holdings (section 4943), jeopardy investments (section 4944), and taxable expenditures (section 4945). Excise tax penalties are imposed for violating these requirements. By requiring these provisions to be included in a private foundation's governing instruments, state law remedies (e.g., surcharging directors or trustees) can be invoked as well as the excise taxes themselves.

either the "public support" tests or other requirements to be classified as public charities.

C. Restrictions on Private Foundations: Chapter 42 Rules

The Tax Reform Act of 1969 established the distinction between private foundations and public charities and imposed significant operating restrictions on private foundations. These mandate a duty of financial loyalty by prohibiting self-dealing, prevent unreasonable accumulations of income by imposing mandatory payout requirements, establish, in effect, a prudent investor rule for foundations by prohibiting the retention of excess business holdings and investment practices that jeopardize the foundation's ability to carry out its exempt purposes, and place limits on program activities and the process of grant making by taxing various types of prohibited expenditures, including lobbying (with a few exceptions) and electoral campaign activities. In addition, the Act imposed an annual 2 percent excise tax on the "net investment income" including capital gains of a private foundation (as explained more fully below).

With the exception of the excise tax on jeopardy investment income and the penalties for self-dealing, violation of these rules results in the imposition of excise tax penalties on the foundation and on those foundation managers who knowingly approved the prohibited expenditure. Five sets of excise taxes exist, with each set entailing an initial tax, the additional tax, and an involuntary termination tax if there continues to be repeated or willful violations. (The IRS has the authority to abate these initial taxes, except in the context of self-dealing, where the violation was due to reasonable cause and not to willful neglect, as long as the matter is timely corrected.)

1. Self-dealing. Section 4941 imposes a tax on various acts of self-dealing between a private foundation and a "disqualified person." An act of self-dealing may be direct or indirect. A "disqualified person" is statutorily defined to include

foundation managers, substantial contributors to the foundation,* owners of more than 20% of the voting power of a corporation, the profit interest in a partnership or the beneficial interest in a trust that was a substantial contributor to the foundation, specified family members of any of these individuals, and corporations and other business entities in which any disqualified persons have more than a 35% interest in voting power, profits or beneficial interests, and elected public officials.

Self-dealing transactions may include the following transactions between a private foundation and a disqualified person: the sale, exchange or leasing of property, the lending of money or other extension of credit, the furnishing of goods, services or facilities, the payment of compensation, the transfer to or use by or for the benefit of, a disqualified person the income or assets of the private foundation.

A number of important exceptions exist, primarily in circumstances where no charge or remuneration is involved. An exception also exists for a transaction between a private foundation and a corporation that is a disqualified person.**

2. Mandatory Payout. Section 4942 requires a private foundation to distribute a minimum amount of money or property for charitable purposes for each year. The minimum mandatory charitable expenditure is an amount equal to five percent of the value of the prior year's noncharitable assets (roughly

* A substantial contributor is any person (including a corporation, partnership, trust or state) who has contributed more than $5,000 to the foundation if the total of his contributions exceeded 2% of the total contributions received by the foundation form its date of creation to the end of the year in which the $5,000 limit was met.

** It is not an act of self-dealing if the transaction occurs pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization. (For this exception to apply, all the securities of the same class as that held by the foundation prior to transfer must be subject to the same terms and these terms must require receipt by the foundation of no less than fair market value.)

equivalent to its endowment). Qualifying distributions are essentially grants, outlays for administration***, and payments made to acquire charitable assets.

3. Excess Business Holdings. To maintain its independence and to ensure its decisions are not influenced by its financial holdings, a private foundation is prohibited under section 4943 from holding (directly or indirectly) more than 20 percent of the voting stock of any corporation or 20 percent of the profit interest in any partnership. If effective control of the business can be shown to be elsewhere, a 35 percent limit may be substituted for the 20 percent limit (There is a 2 percent de minimus rule in the case of measuring indirect holdings by attribution).

Three exceptions exist: 1) for a business deriving at least 95 percent of its gross income from passive sources; 2) for holdings in a functionally related business—a business that is substantially related to the achievement of the foundation's exempt purposes, as long as certain other conditions exist (e.g., work is performed without compensation for the convenience of employees that consists of selling contributed merchandise, or that is carried on within larger aggregate of similar activities or endeavors that are related to the exempt purposes of the foundation; and 3) for program-related investments.

A foundation has a five-year grace period (and in certain circumstances involving the exercise of diligent efforts, an additional five years may be permitted) to diversify a portfolio or reduce the excess business holdings to permissible levels without incurring a penalty in cases where those excess holdings are received by gift or bequest.

4. Jeopardizing Investments. A tax is imposed by section 4944 on investments of a private foundation that are considered risky using a prudent investor standard. An investment is considered to jeopardize the carrying out of

*** Proposed legislation would eliminate, in whole or in part, the ability to treat most administrative expenses as qualifying distributions.

the foundation's exempt purposes if the foundation managers in making the investment, failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of the investment, in providing for the long-term and short-term financial needs of the foundation in carrying out its charitable purposes. No category of investments is treated as a per se violation of these rules.

5. Taxable Expenditures. Unlike the restrictions described previously that involve violations of loyalty and care, the restrictions under section 4945 regulate the activities and charitable purposes for which private foundation managers may expend the foundation's funds. These rules constrain or prohibit legislative activities, electioneering, grants to individuals, and grants to noncharitable organizations. Prohibited expenditures are deemed taxable expenditures.

The penalties for violations of section 4945 may be imposed on the foundation as well as its managers. Five categories of taxable expenditures exist and will subject the foundation and its managers to excise taxes if made (and potential involuntary termination of exempt status if continuing or not "corrected"):

- Propaganda and lobbying. Section 4945(d) prohibits foundations from expending any amount to influence legislation if it is for a direct lobbying communication or a grass roots lobbying communications or efforts to affect the opinion of the general public. Attempts to influence legislation generally include communications with a member or employee of a legislative body or with an official or employee of a government executive department engaged in formulating legislation. (Thus, the general rule permitting other charitable organizations, such as public charities or social welfare organizations to engage in legislative activities is inapplicable to private foundations). Three exceptions

exist and are discussed in greater detail below at V., "Lobbying and Political Activities."

- Influencing the Outcome of an Election. Attempts to influence the outcome of a specific public election or to carry on a voter registration drive are taxable expenditures. This first prohibition generally parallels the prohibition on political campaign activities by all charitable organizations. However, if certain criteria are met, a private foundation may engage in voter registration drives.

- Grants to Individuals. As a general rule, grants to individuals are not prohibited. However, Code section 4945(d)(3) defines as taxable expenditures grants to individuals for travel, study, scholarships or similar purposes if the foundation has not obtained advance approval from the Service.

- Grants to Other Foundations. As a general rule, a private foundation cannot make a grant to another private foundation. Such grants are subject to excise tax unless the foundation exercises "expenditure responsibility" for the duration of the grant, requiring the foundation to investigate the potential grantee prior to making the grant and requiring the grantee to use the funds only for the purposes for which it was made, to comply with private foundation expenditure restrictions, and to provide progress reports. These are common grant making practices among most private foundations with professional staff. However, expenditure responsibility requires the grantor foundation to report to the Service on the expenditures made by the grantee, an added administrative burden in excess of usual practice. There are no restraints on a private foundation's ability to make grants to a Code section 501(c)(3) public charity.

- Expenditures for Noncharitable Purposes. This prohibition applies to any grant to an organization that is not exempt under section 501 (c)(3), unless certain conditions are satisfied.*

* These conditions are: (1) the making of the grant constitutes a direct charitable act or program-related investment; 2) the grantor exercises "expenditure responsibility"; and 3) the grantee agrees to maintain the grant funds or other assets in a separate fund dedicated exclusively to exempt purposes.

IV. SOCIAL WELFARE ORGANIZATIONS DESCRIBED IN SECTION 501(C)(4)

A. Basic Requirements for Exemption

Definition. An organization may qualify for exemption from federal income tax as a "social welfare organization" under Code section 501(c)(4) provided it is not organized for profit, it is operated exclusively for the promotion of social welfare, and no private individual or organization benefits from the net earnings of the organization.

Requirements in the Organizing Documents. Federal income tax rules require no magic language to be included in a social welfare organization's governing instrument, but it is prudent to include a provision precluding the distribution of the organization's net assets to private individuals or organizations upon dissolution. A start-up organization may take one of two approaches when preparing its governing instruments above and beyond complying with specific state not-for-profit laws – a restrictive approach or a non-restrictive approach.

To ensure that the IRS will respect its tax-exempt status as a social welfare organization, the organizing documents should restrict the primary activities to those that further (in some way) the common good and general welfare of the people in the broad-based community (e.g., bringing about civic betterment and social improvements).**

The Operational Test. Federal income tax rules provide broadly that a social welfare organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the "common good and general welfare" of the people of the "community". (For example, if it focuses its

** The organization should file with the Internal Revenue Service Form 1024, Application for Recognition of Exemption Under Section 501(a), and a conformed copy of its charter and by-laws, if any. This form requires detailed descriptions of the organization's past, present and planned activities. For example, the organization must itemize and describe each proposed activity, and rank the activities based on the relative time and other resources devoted to them. The form also requires disclosure of the organization's current-year balance sheet, and current and projected (generally a proposed two-year budget) income statements.

activities primarily on improving the availability, efficiency, and quality of health care within the community.) Whether the community identified by an organization or the identified beneficiaries of that community are sufficiently large targets of the organization's activities to avoid the prohibition of private benefit and to justify federal income tax exemption as a social welfare organization will be determined by the Internal Revenue Service based on the facts and circumstances of each particular case. It is clear, however, that the Internal Revenue Service prefers that programs provide support to a broad-based community. There is no doubt that all of the citizens of any state constitute a broad enough class to satisfy this requirement.

Social welfare organizations do not face the same restrictions as private foundations (or even the lesser restrictions imposed on public charities) in pursuing legislative and political activities. In general, a social welfare organization may further its social welfare purposes by seeking legislation germane to its programs without jeopardizing its federal income tax-exempt status. It may also engage in some political activities so long as they do not constitute the organization's "primary" activity. (By contrast, no more than an "insubstantial part" of the activities of a Code section 501(c)(3) public charity can constitute lobbying and it is prohibited from engaging in any political campaign activities.)

B. Comparison with Section 501(c)(3) Organizations

1. Similarities.

   (a) Neither organization may be organized or operated for private gain;

   (b) Neither organization may participate or intervene in any political campaign on behalf of or in opposition to any candidate for public office;

(c) Each is subject to taxation on its unrelated business income;

(d) Neither may be operated for profit; and

(e) The concepts of "social welfare" and "charity" may overlap.

2. Distinctions.

(a) A social welfare organization may engage in legislative activities so long as its "primary" activity is the promotion of social welfare. A Code section 501(c)(3) organization may only engage in an "insubstantial part" of such activities (See V. "Lobbying and Political Activities");

(b) Social welfare organizations have a very limited ability to attract tax-deductible charitable contributions;

(c) Social welfare organizations, unlike private foundations, are not subject to a 2% excise tax on net investment income, including capital gains or to excess business holdings restrictions;

(d) Social welfare organizations are not subject to the operational restrictions imposed on private foundations, such as mandatory distributions, and the applicable private foundation excise taxes when those restrictions are violated, except for a comparable, but different form of self-dealing.

V. LOBBYING AND POLITICAL ACTIVITIES BY SECTION 501(C)(3) AND 501(C)(4) ORGANIZATIONS

The prohibition against participation by both 501(c)(3) and 501(c)(4) organizations in a political campaign on behalf of or in opposition to a candidate ("electioneering") is absolute. In contrast to electioneering, certain forms of lobbying and other legislative activities are permitted, to varying degrees, by private foundations, public charities and social welfare organizations. The greatest limitations, by far, are imposed on private foundations.

501(c)(4) Social Welfare Organizations. Lobbying is considered to be an exempt purpose for a social welfare organization under Code section 501(c)(4); it is not for a Code section 501(c)(3) organization, whether or not it is a private foundation.

Section 501(c)(3) Organizations. "No substantial part" of a section 501(c)(3) organization may consist of "carrying on propaganda, or otherwise attempting to influence legislation." If an organization devotes a substantial part of its activities to lobbying it does not qualify for exemption under section 501(c)(3).* Public charities, less restricted than private foundations, may elect to devote some part of their activities to lobbying, so long as they put their expenditures to the substantial part test.**

Private Foundations. Private foundations are the most restricted in their permissible lobbying activities among the different forms of tax-exempt organizations. In enacting section 4945, Congress concluded that more effective limitations must be placed on the extent to which tax-deductible and tax-exempt funds can be dispensed by private persons and that these limitations for "taxable expenditures" must involve more effective

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* The limitation on political activity is applicable to the organization itself and not its officers, directors, and employees acting in their individual capacities, unless the organization ratifies their activities.

** The substantial part determination is made using one of two tests. It is based on all the facts and circumstances of a particular case or the expenditure test of sections 501(h) and 4911 which is based on expenditures associated with particular activities. An organization that has not made the section 501(h) election to have the substantiality of its lobbying activities determined under the expenditure tests, is subject to the substantial part test.

sanctions.*** Three important exceptions exist to the direct and grassroots lobbying prohibitions in section 4945:

1. Lobbying communications which include information containing nonpartisan analysis, study or research, that are directed to legislators and the public to enable the formation of an independent opinion. (For example, examination and discussions of broad social and economic problems are excluded from the definition of lobbying.);

2. Technical assistance provided to a governmental body or committee in response to a written request to the foundation is excluded;

3. The final exception is for expenditures made to influence proposed legislation that could affect the powers and duties of the foundation, its existence or tax exempt status.

A private foundation will not be subject to excise tax or otherwise jeopardize its exempt status if a grantee uses grant funds for expenditures which the foundation is prohibited from making, so long as funds are not "earmarked" for the prohibited activities.

The penalties for violation of section 4945 taxable expenditures may be imposed on the foundation, as well as its managers. The initial tax on the organization is equal to 10% of the amount expended, while the second tier tax is equal to 100% of the amount involved.*

*** In addition, Section 4942(d)(2) defines taxable expenditure as any amount paid or incurred by a private foundation used to "influence the outcome of a specific public election, or to carry on, directly or indirectly any voter registration drive." Despite these prohibitions, both public charities and private foundations may conduct or fund a voter registration drive without penalties, as long as it is conducted in a non-partisan manner and certain rules of section 4945(f) are met.

* The first level tax on a manager who knowingly approved the expenditure is equal to 2-1/2% of the amount involved, with a $5,000 ceiling, and the second tier tax is 60%, with a $40,000 ceiling. Managers are not subject to the tax if their participation was not wilful and was due to reasonable cause. In addition, if more than one person is liable for making a taxable expenditure, all such persons are jointly and severally liable. I.R.C. §4945(b) and (c).

VI. THE PROPOSED PREMERA TRANSACTION

The proposed Premera transaction is structured to prevent incurring any federal income tax on the gain from the sale of New Premera Shares to the public. The Plan contemplates that a section 501(c)(4) social welfare organization will receive, monetize, and distribute conversion proceeds to the Charitable Trusts, two section 501(c)(3) private foundations, rather than the more frequently used transaction structure of distributing health conversion proceeds directly to a private foundation or, in other cases, directly to either a social welfare organization or a public charity.

The two-tier tax-exempt structure is designed to achieve several advantages. In the short term, using a section 501(c)(4) social welfare organization to receive, monetize and distribute conversion proceeds to the Charitable Trusts is intended to:

- eliminate a foundation excise tax on the gain from the sale of the New Premera Shares;
- eliminate minimum distribution requirements until the New Premera Shares are liquidated, to provide the cash required to make grants; and
- eliminate any concerns about "excess business holdings"; and
- minimize reporting and public disclosure requirements.

Using a second tier private foundation to serve as the ultimate steward of the charitable mission and to distribute grants within each state will achieve certain longer-term benefits. Specifically, a Code section 501(c)(3) charitable organization (a private foundation as well as a public charity) tends to be more "respected" by the public (and others with whom it has contact) than a Code section 501(c)(4) social welfare organization. In addition, the exemption mandating more restrictive rules regarding lobbying activities may be viewed as more desirable than comparable state imposed restrictions.

Thus, the primary objective of the two-tier structure appears to be to achieve both the greater tax efficiency provided by a section 501(c)(4) social welfare organization and the enhanced accountability provided by the restrictions imposed on section 501(c)(3) organizations, especially private foundations.

Excise Tax on Net Investment Income. Another primary purpose of the two-tier structure is to avoid the excise tax on net investment income, imposed on private foundations at the rate of 2%, but not on section 501(c)(4) social welfare organizations.

Section 4940(a) imposes on private foundations (other than exempt operating foundations) a tax of 2% of net investment income, including capital gains income. Net investment income is income from all passive sources, including rents, royalties, and net capital gains income, less certain related expense deductions. (Private foundations may reduce the tax to 1% if they make additional distributions for charitable purposes. It is not clear that the techniques required to reduce the excise tax from 2 percent to 1 percent would be available in a start-up situation like this. Certain proposed legislation would reduce the Code section 4940 excise tax on the net investment income of private foundations from 2% to 1% in all cases).

As noted, the foundation excise tax is imposed on net capital gains (long and short term) in addition to dividends, interest, royalties, and rents. For this purpose, it is likely that for purposes of measuring gain on the sale of the New Premera shares, the tax basis in such shares will be nominal.

Consequently, the capital gains realized by the section 501(c)(4) Foundation Shareholder will not be subject to the foundation excise tax, as the gains would be if the Shares were distributed directly to and monetized by a private foundation. Share proceeds also may be invested in a diversified investment portfolio and managed by Foundation Shareholder over time without incurring the excise tax on net investment income that would be due if, alternatively, the equivalent cash (endowment) were invested and managed by the Washington Charitable Trust and the Alaska Charitable Trust.

Excess Business Holdings. Avoiding certain private foundation restrictions at the outset provides additional reasons for the proposed two-tier structure using an intermediary social welfare organization. A private foundation, in receiving the New Premera Shares directly, would be subject not only to the foundation excise tax but to restrictions on excess business holdings (generally more than 20 percent of the voting stock of any corporation) were such shares to be held more than 5 years. Thus, its managers' decisions regarding the timing of the sale of the New Premera shares could be driven by the need to timely divest in accordance with relevant excess business holdings rules and regulations, not by investment considerations alone, such as the best market conditions and rate of return. A social welfare organization is not subject to excess business holding restrictions.

Maximizing Rate of Return. The two-tier structure may not only provide greater flexibility to enhance tax efficiency but also to maximize the rate of return. If maximizing share value takes longer than expected due to market conditions, a 501(c)(4) has greater flexibility to take the necessary time and to employ the necessary investment expertise. Because of the substantial amounts of consideration often paid in connection with conversions, retained equity can serve as a hedge against the possibility that the valuation is incorrect or incapable of being determined with absolute precision as of the date of the conversion. (From a fiduciary point of view, however, an evaluation must be made of the risks inherent in maintaining such an investment, since it cannot be assumed that the value will always increase or increase at a rate higher than the rate of return on a more diversified investment portfolio.)

Thus, establishing Foundation Shareholder under section 501(c)(4) to receive and manage the monetization of the New Premera shares may allow greater flexibility to sell the Shares over a longer period of time under potentially more advantageous market conditions. It may also permit Foundation Shareholder to invest the proceeds, manage a diversified portfolio, and distribute funds to the two 501(c)(3) private foundations (the Washington and Alaska Charitable Trusts) only on as "as needed" basis when they require cash for administrative expenses and to distribute grant funding. This would

initially obviate the need for the Charitable Trusts to manage their endowments and would eliminate the foundation excise tax on any private foundation investment income on those endowments. Thus, enhanced tax efficiency and potentially a higher net return on investment may be achieved with a two-tier structure.

Mandatory Minimum Distribution Requirement. Equally important, the Foundation Shareholder, as a section 501(c)(4) social welfare organization, would not be subject to the mandatory minimum distribution requirements compelling private foundations to make grants annually amounting to no less than 5% of the fair market value of the prior year's assets. (It would also avoid the difficulty and expense of appraising the New Premera shares before they were marketed.) The difficulty of making grants of sufficient value when the endowment assets are primarily illiquid, while simultaneously managing the monetization of the Shares and the start-up of a new foundation, is avoided by splitting responsibilities in the two-tier structure.

VII. REASONS WHY PREMERA PLAN MAY BE DISADVANTAGEOUS

Using both the 501(c)(4) and 501(c)(3) exempt organizations provides the benefits of each only if management for each entity is careful to observe the differences in restrictions, purpose, governance, administration and filing requirements. The increased administrative cost of maintaining three exempt organizations and the potential difficulty of explaining the differences among the three to the public should also be considered.

The primary disadvantage of the proposed Premera Plan is that it does not provide as much tax certainty for state operational planning purposes as the other plans herein considered. As set forth above, in order to qualify as a Code section 501(c)(4) organization an organization must "primarily" engage in activities consisting of promoting the "common good and general welfare" of the people of the "community." Even though the Foundation Shareholder will receive cash (or other assets) from Premera (or New Premera) in addition to the New Premera Shares and even though it is expected to use such cash (or other assets) over the thirteen years it is expected to exist to promote the common good and general welfare of the citizens of Washington and Alaska, it still may not qualify for recognition as a section 501(c)(4) organization unless it is determined that its activities consisting of promoting the common good and general welfare of the citizens of Washington and Alaska are, in the aggregate, its "primary" activities. There is no way to be certain how the IRS will rule in this regard. Among the factors that it would likely consider would be, the relative significance of the assets of the Foundation Shareholder other than the New Premera Shares (and the proceeds from the sale of the Shares) and the exact nature and extent of the activities constituting the promotion of the common good and general welfare of the citizens of Washington and Alaska.

For this reason and to avoid the possibility that the IRS will not recognize the Foundation Shareholder as a section 501(c)(4) organization, it may be necessary to reserve sufficient cash to pay any tax liabilities (interest and penalties) that would result were the IRS not to determine that the Foundation Shareholder is a section 501(c)(4) (or- a section 501(c)(3) organization.) Alternatively, it may be necessary to delay funding the Foundation

Shareholder with the New Premera Shares until a definitive determination is obtained from the IRS regarding the tax exempt status of the Foundation Shareholder. The process required to obtain such a definitive determination would likely take no less than three months and could take as many as twelve months or more.

VIII. ALTERNATIVES TO PREMERA PLAN

A. Solely a 501(c)(4)

Establishing only a social welfare organization under section 501(c)(4) is an alternative to the current two-tier plan. Foundation Shareholder, in addition to its current planned role, would be responsible for the stewardship of the charitable endowment and nonprofit mission, as well as planning and operating an active grant making program, responsibilities more typically undertaken by private foundations. Social welfare organizations are typically advocacy organizations with significant lobbying activities. Public health and community advocates usually prefer the transparency, accountability and governance provided by a private foundation operating under Chapter 42 restrictions, and that is approved and regulated by the I.R.S. (See IX., "Healthcare Conversion Transactions in Other States: Lessons Learned.")

Some healthcare conversion organizations are operating as section 501(c)(4) social welfare organizations with certain 501(c)(3) restrictions, either as required by state statute or adopted as by-laws. (See "A Profile of New Health Foundations: Health Plan Conversions" chart at I., "Executive Summary.") By-laws may be changed and thus, are subject to political and industry pressures. The tax efficiencies and greater freedom of a 501(c)(4) organization to lobby and advocate with no mandatory grant making requirements creates both additional risks and benefits. (A 501(c)(4) may accept charitable contributions, but the possibility of future donations is remote, so this is not a significant advantage compared to a private foundation structure.)

Obtaining 501(c)(4) recognition with 501(c)(3) governing instruments. An additional risk is a potential challenge by the IRS. Even though several section 501(c)(4) healthcare conversion organizations operate with 501(c)(3) restrictions, a social welfare organization should carefully consider the extent to which it adopts governing instruments with restrictions unique to section 501(c)(3)

charitable organizations if it seeks to avoid the status of a private foundation. This is especially true where it is not required by state healthcare conversion statutes.

The Internal Revenue Service recognizes that many organizations could simultaneously qualify for exempt status under either section 501(c)(3) or section 501(c)(4). In fact, the Internal Revenue Service has ruled that organizations that are not exempt under section 501(c)(3) for a period of time because they failed to file timely applications for recognition of exemption may qualify as exempt under section 501(c)(4) for that period. This is because activities of an organization may simultaneously qualify as "charitable" and "social welfare" activities; and, because federal income tax rules grant social welfare organizations greater organizational and operational latitude than section 501(c)(3) charitable organizations.* However, the stated position of the Internal Revenue Service is that if a social welfare organization qualifies under both section 501(c)(3) and section 501(c)(4) and is a private foundation, it cannot avoid private foundation status by then claiming exemption solely under section 501(c)(4).**

B. Solely a 501(c)(3)

Establishing two private foundations without the intermediary section 501(c)(4) organization now envisioned has tax planning, public relations, cost, and administrative benefits. The ability to forecast with greater certainty total tax costs and to operate from the beginning under the 501(c)(3) private foundation restrictions preferred by healthcare and community advocates (and used most often in other healthcare conversion transactions) may offset to some extent the

* For example, there is no organizational test and there is no deadline on applying for exemption under section 501(c)(4). In addition, organizations exempt under section 501(c)(4) may engage in germane legislative activities other than intervention in a political campaign, without the restrictions imposed on section 501(c)(3) organizations. And, a social welfare organization exempt under section 501(c)(4) may engage in substantial non-exempt activities.

** See IRM 7.26.7.1.3(4) Internal Revenue Manual Chapter 7.26 – Private Foundations Manual 7.26.7.1.3 – Relationship of Private Foundation Status With Exempt Status (10-20-1998).

loss resulting from the imposition of the foundation excise tax on the gain from the sale of the New Premera Shares (and on net investment income as the private foundation manages the endowment from the share proceeds), which, in the aggregate, could equal (or even exceed) 2% of the gross proceeds from the sale of the New Premera Shares.

C. An Expanded Exempt Purpose for a 501(c)(4) in the Proposed Two-Tier Plan

Another alternative to help minimize the risk that the IRS will not conclude that Foundation Shareholder has adequate social welfare purposes is to expand the role of Foundation Shareholder to include a role in overseeing and convening the public hearings and meetings among each state's stakeholders to decide the best use of the conversion's charitable proceeds.

Selecting another social welfare purpose in addition to those now proposed would enhance the likelihood that the IRS would recognize and respect the 501(c)(4) status of Foundation Shareholder. Studying and analyzing the public healthcare needs and policy issues, and conducting public hearings to determine and disseminate information about the mission and goals of the Charitable Trusts' grant making would be proper "social welfare" purposes. . Even advocacy on behalf of the healthcare needs of the people of the States of Washington and Alaska (perhaps, focused on low-income health needs) might be a politically acceptable part of its mission.

Achieving consensus among all of the different constituencies claiming a role in the decision-making process about how the conversion funds should best be spent and then establishing the governance structure, staffing, mission, and grant making focus of the Charitable Trusts may take almost a year, if the histories of other health conversion foundations are any guide. (See IX., "Healthcare Conversion Transaction Histories in Other States" chart.) During this initial time period the tax and other benefits of a 501(c)(4) are retained, without the pressure

and restrictions of operating a private foundation, especially if the start-up of the Foundation Shareholder and the Charitable Trusts is staggered.

On the other hand, consumer advocates and others may view with skepticism the role of the Foundation Shareholder as a social welfare organization on account of its ability to engage in certain lobbying and its relative freedom from scrutiny. This may be so, even though there is a mission and administration that is separate and distinct from its role as an entity to receive the New Premera Shares, monetize the Shares and fund the Charitable Trusts with the proceeds of sale.

IX. HEALTHCARE CONVERSION TRANSACTIONS IN OTHER STATES: LESSONS LEARNED

Most foundations established as a result of health plan or system conversions are 501(c)(3) private foundations. (See "A Profile of New Health Foundations" chart in I., "Executive Summary.") Several health conversion organizations are recognized as social welfare organizations pursuant to section 501(c)(4), but almost without exception, they operate with many section 501(c)(3) restrictions in their by-laws, either as required by state statute or as adopted by their boards (often at the behest of the governor or attorney general of the state). A few conversion organizations are structured as supporting organizations as defined by section 509(a)(3).

No recognized body of law provides an infallible bright line test for distinguishing clearly between a 501(c)(3) and 501(c)(4) organization. Thus, even though other states have experience in structuring health conversion foundations as 501(c)(4) social welfare organizations with certain 501(c)(3) restrictions contained in their by-laws (e.g., limits on lobbying activities), the risk is not eliminated or even necessarily diminished that the IRS could determine that such a health care conversion foundation is, in fact, a 501(c)(3) private foundation, not a 501(c)(4). Applied retroactively, such a ruling would require the payment of excise taxes on the net investment income, including capital gains by the Charitable Trusts.

State attorneys general and insurance commissioners are exercising more stringent regulatory review of proposed conversions (strengthened by the enactment of state conversion statutes). They are ensuring the protection of charitable assets and the historic nonprofit purposes of health plans. Essential to this protection is making objective determinations about the receipt of fair market value and the consequences of the conversion on healthcare delivery to citizens of the state. State attorneys general have filed lawsuits not only to set aside the full value of conversion proceeds for charitable use, but to maintain and protect the charitable assets from distribution to out-of-state charitable conversion foundations by health systems merging and acquiring other plans in

other states. Lengthy public comment periods, intervention by consumer groups and professional organizations, and public hearings with testimony by independent experts retained by the state are common. In 2002 and 2003, the insurance commissioners in Kansas and Maryland refused to approve healthcare conversion transactions because they were "not in the public interest".

Consumer health advocates also have successfully demanded greater public engagement, not only during the conversion review process, but also with respect to decisions concerning the resulting charitable foundation's structure, mission, governance and board independence, and ongoing grant making operations. Whether a 501 (c)(3) private foundation or public charity, a 501 (c)(4) social welfare organization or a 509 (a)(3) supporting organization is chosen as the charitable structure, governance that ensures accountability, independence, and transparency is increasingly judged as best practice. As noted previously, most of the charitable organizations structured as 501 (c)(4) organizations have adopted by-laws imposing 501 (c)(3) private foundation restrictions. (California, North Carolina, Colorado, Maine and Ohio have statutes requiring health conversion 501 (c)(4) organizations to adopt such restrictions.) The power to appoint board members, board independence and composition, and the role of community advisory committees have emerged as critical issues. Consensus about model by-laws and governance, as well as best practice in mission and charitable grant making for health care conversion foundations has begun to develop.

A review of the conversion transaction histories in other states, including California, reveals that the two-tier structure proposed in the Premera conversion transaction establishing Foundation Shareholder as a 501(c)(4) organization to, among other things, receive and monetize the New Premera Shares, and then distribute share proceeds to two charitable trusts, organized as section 501(c)(3) private grant making foundations, appears to be in the minority if not, as contemplated, unique. Choice of tax status is revocable, and a few healthcare conversion foundations have sought to change their tax status successfully after gaining experience in philanthropy.

CONVERSION TRANSACTION HISTORIES

California	BCC transferred a majority of its assets to a for-profit sub, WellPoint Health Networks, Inc. in 1993 without formal charitable distribution. Negotiations with Department of Corporations ensued, resulting in BCC's agreement to distribute all of its assets, $3.2 billion, to two newly-formed charitable grant making organizations, the California Endowment, a 501 (c)(3) private foundation and the California Healthcare Foundation, a 501 (c)(4) social welfare organization (designed to spend down its assets in contrast to the Endowment). In 1996, pursuant to a recapitalization by and among WellPoint, BCC and the two nonprofits, the 501 (c)(3) Endowment received a donation of $800M in cash from BCC, BCC's portion of a special $10.00 per share dividend distributed to shareholders of WellPoint common stock. The 501(c)(4) Healthcare Foundation received a donation of equity which converted into new WellPoint common stock following conversion of BCC to for-profit status and its subsequent merger with WellPoint. Independent consultants were retained to determine valuation and the mission, governance and structure of the foundations. Board selection for the endowment was applauded as extremely thorough and fair, using a consortium of executive of executive search firms.
Colorado	BCBSCO filed a proposal to convert in 1997 after merging with BCBS of Nevada, proposing to distribute 100% of its stock of the holding company to two 501 (c)(4) foundations. Following a public comment period, the plan proposed to distribute net proceeds of public offering to one 501 (c)(3) foundation. Consumer groups intervened and hearings to determine mission, governance, and structure occurred in 1997, resulting in the establishment of The Caring for Colorado Foundation, a 501 (c)(4) with a community advisory committee and certain by-laws adopting restrictions characteristic of a 501 (c)(3). Thereafter, BBSCO agreed to affiliate with Anthem and after negotiations (and bids from WellPoint), Anthem agreed to pay $155M, contributing $140M to the Caring for Colorado Foundation. The Governor, the Insurance Commissioner and consumer groups negotiated the power to appoint the Board of Directors and the degree of community representation on the Board. In February 2001, Anthem filed its demutualization plan in Indiana. It was approved in October 2001 when Anthem launched its IPO.
Connecticut	In July 1997, the Department of Insurance approved the merger of BCBSCT (a mutual insurer since 1984) with Anthem Insurance Companies. The Attorney General named a Special Attorney General, recusing his office from considering the charitable trust issues in the merger. In 1997, the state comptroller and a coalition of advocacy and labor organizations filed separate suits against Anthem to protect policyholder rights and to preserve charitable assets now possessed by Anthem. The Special Attorney General also filed a suit to prevent Anthem from acquiring and transferring out of Connecticut assets subject to a charitable trust, alleging that Anthem and BCBSCT breached their fiduciary duties by refusing to maintain the assets of the BCBSCT plan for charitable purposes. In June 1999, Anthem settled the litigation, agreeing to transfer approximately $41 million to the Anthem Foundation in Connecticut. To ensure community and consumer representation the state established the Connecticut Health Advancement and Research Trust (CHART), a 501 (c)(3), with the power to appoint the Anthem Foundation board. The new Anthem Foundation is incorporated as a 509 (a)(3) supporting organization to CHART. The Connecticut Health Foundation, originally established as a 501 (c)(4) organization with certain 501 (c)(3) restrictions incorporated in the by-laws, converted to a 501 (c)(3) private foundation in July 2002 at the behest of the Attorney General.

Georgia	In May 1996, Georgia BCBS filed for conversion and established itself as a privately held for-profit company, Cerulean Companies, Inc. The transaction was approved without any assessment of the plan's charitable trust obligations. Class action lawsuits followed and on July 8, 1998, the plaintiffs and Cerulean/BCBSGA reached a settlement resulting in the transfer of $70-$80 million to a new charitable foundation with board members designated by plaintiffs, Cerulean BCBSGA and prominent nonprofit organizations. Well-point Health Networks subsequently purchased Cerulean and litigation ensued, resulting in a higher offer from Wellpoint. In March 2001, the Georgia Insurance Commission approved the acquisition which increased the foundations's endowment to $124 million.
Kansas	After litigation during 1998 and 1999 between BCBSK, the Attorney General, and the insurance commissioner concerning whether BCBSK had a charitable trust obligation to the people of Kansas and whether it had breached its fiduciary duty by using substantial corporate assets in an attempt to merge with BCBS-KC, the court found in January 2000 that BCBSK possessed charitable assets. In August 2000, the Attorney General, the Insurance Commissioner and BCBSK reached a settlement, creating a new foundation, the Sunflower Foundation, a 501 (a)(3) supporting organization to which BCBSK contributed $75 million. Consumer groups, initially very positive with the settlement, questioned the Kansas Attorney General's unique decision to establish the foundation as a supporting organization to the Kansas Attorney General's office, rather than as an independent 501 (c) (3) private foundation. Advocates were concerned that the foundation might be vulnerable to undue political influence in the future. After considering whether to challenge the Attorney General for overreaching her authority, the state legislature amended the Kansas Open Records Act to apply its sunshine provisions specifically to the Sunflower Foundation. In May 2001 BCBSK and Anthem Insurance Companies announced their plans to affiliate in a sponsored demutualization, providing $370 million to BCBSK ($190 million for BCBSK's outstanding expenses and $180 million to policyholders). After the Insurance Commissioner retained independent financial and economic health experts, convened a four month public comment period and several days of public hearings, including testimony analysing likely premium increases of over $248 million over five years for individuals and small groups, Anthem added a $25 million rate stabilization fund. In February 2002, the Insurance Commissioner rejected the proposed conversion, finding it to be unreasonable to policyholders, "not in the public interest", and "hazardous and prejudicial to the insurance buying public." BCBSK appealed the Commissioner's ruling to the County District Court that had vacated the Commissioner's order in June 2002, finding she had exceeded her authority. The Commissioner appealed the case to the Kansas Supreme Court and on August 5, 2003, the Court ruled in favor of the State, preserving the ruling by former Insurance Commissioner (and now, Governor) Kathleen Sebelius, who vetoed the conversion and sale. In research conducted by her office, the then-commissioner found that the largest premium increases would fall on small business owners and their employees and residents with individual Blue Cross insurance policies. An independent analysis by PricewaterhouseCoopers also concluded that Anthem would need to raise premiums by 7% for these two groups in order to achieve a 2.5% increase in profits.

Kentucky	In a 1993 merger between Anthem Insurance Companies and Kentucky BCBS, the Kentucky Insurance Commissioner approved the transaction without any consideration of BCBSKY's charitable assets. After a routine investigation by the Department of Insurance in 1996 raised questions about Anthem's use of reserves, the Attorney General filed a lawsuit against Anthem seeking to recover millions of dollars in charitable assets and reimbursement of premium increases. After several years of litigation, the Attorney General and Anthem announced a settlement of the charitable trust issue in December 1999 when Anthem agreed to place $45 million into a newly created 501 (c)(3) foundation. During the interim period, the $45 million was held in an interest bearing state governmental trust account. The members of the advisory board were appointed by the Franklin Circuit Court upon nomination by the Attorney General and were charged with making recommendations to the Court about the structure and composition of the new foundation. Subsequently, in early 2000, the Kentucky General Assembly began a legislative effort, challenging the enforcement authority of the Attorney General and the power of the Court's jurisdiction over the charitable assets, seeking to establish the foundation as a "quasi-governmental entity". Over 40 consumer and philanthropic groups urged the Governor to veto the legislation, which he signed into law in April 2000. A 35-member community advisory committee was appointed by the Governor to set up the foundation. In June 2001 Anthem filed its demutualization plan with the Indiana Department of Insurance providing policyholders in some states with shares in the new company but not policy holders in Colorado, Maine, New Hampshire or Nevada.
Maryland, Delaware, District of Columbia	On March 5, 2003, the Maryland Insurance Commissioner announced his decision to deny the application by non-profit Blues plan, Carefirst, to convert and be acquired by WellPoint. Carefirst is the holding company controlling BCBS plans in Maryland, Delaware and the District of Columbia. Because Carefirst is the Blues insurer in D.C. and Delaware, review and approval of the proposal was required in those jurisdictions as well. In 2002, the D.C. Insurance Commissioner held public forums but has indicated that if the Maryland decision were upheld, he would not continue to review the proposal. WellPoint had asked the Delaware Insurance Commissioner to put her review on hold. The Maryland Insurance Commissioner, after contracting with four experts and conducting five public hearings, determined that the conversion was not "in the public interest", citing the violation by Carefirst's Board of its fiduciary duties by failing to upheld its non-profit mission and to conduct appropriate due diligence in deciding whether to sell the plan. He concluded the Board's approval of unreasonable compensation packages for executives constituted a violation of the conversion statute and dismissed the argument that Carefirst needed greater access to capital funding, ruling that Carefirst is "financially stable" and that "data clearly support the notion that bigger is not normally better." A few days following this decision, legislation was introduced in the Maryland General Assembly to make Carefirst a more responsible nonprofit organization by changing certain board members, stating its charitable mission in the statute, preventing conversion to for-profit status for five years, and establishing certain other requirements for the nonprofit. Passed on April 7, 2003, it later received the Governor's approval. The Blue Cross Blue Shield Association then acted to revoke CareFirst's license to use the name and mark and litigation followed. A compromise was reached reducing the extent to which state officials selected replacement directors. State and federal investigations arising from the failed conversion continue.

Missouri	After several years of litigation arising out of the 1994 conversion of BCBSMO to the for-profit Right Choice, the Missouri Foundation for Heath was created as a 501 (c)(4) organization in 2000 pursuant to a settlement agreement among BCSBSMO, the Attorney General and the Department of Insurance. In November 2000, the Foundation received almost $13 million in cash and 15 million shares (80%) of the common stock of RightChoice Managed Care of St. Louis (worth approximately $400 million at the time). In 2001 WellPoint purchased RightChoice, increasing the value of the Foundation's endowment to nearly $1 billion upon the completion of the RightChoice merger in 2002. The Foundation is a 501 (c)(4) but has adopted by-laws containing many 501 (c)(3) restrictions.
New Hampshire	In January 1999 Anthem Insurance Companies announced its plan to acquire BCBSNH for $120 million and to fund a newly-created 501 (c)(3) charitable health foundation, the Endowment for Health, Inc, with $83 million of the sale proceeds. The non-profit BCBSMA also bid, filing papers with the new Hampshire Attorney General arguing that the common-law standard of dissolution of a non-profit corporation had not been met by Anthem in its proposal because a viable option existed that would enable BSBCNH to continue as a non-profit through affiliation with the nonprofit Massachusetts plan. After a series of seven public hearings in 1999 concerning the plan for the health foundation, the Attorney General approved the proposed charitable trust plan, which was challenged in Probate Court by consumer groups unsuccessfully. After a 3-day public hearing on the proposed sale, the Department of Insurance approved the sale of BCBSNA to Anthem in October 1999, imposing 18 conditions on the new company, including: 1) creating a local advisory board to be consulted before significant business changes including levels of service coverage and employment are made, 2) maintaining community benefits and health coverage for lower income individuals, 3) maintaining provider network comparable to BCBSNH and 4) reporting verbal and written complaints received to the Department of Insurance.
New York	In 1997 Empire BCBS filed conversion documents, having agreed to transfer $1 billion of its charitable assets to a nonprofit foundation. After a series of public meetings, the Greater New York Hospital Association and 1199/SEIU union expressed interest in taking over Empire. Empire rejected the proposal. In 1999, the New York Insurance Department held three public hearings on the conversion and approved certain aspects over which the Department had jurisdiction. In May 2000, after a year of negotiations with Empire, Attorney General Spitzer approved the valuation and foundation aspects of the conversion plan. In June 2000, after six years of opposing the conversion, the Greater New York Hospital Association and 1199/SEIU approved it when Empire offered to give half of the $1 billion in charitable assets to both groups. In January 2002, the state legislature passed a bill sought by Governor Pataki, reallocating 95% of the charitable assets to fund salary increases of 13% for 1199/SEIU employees over three years, preserving 5% of the funds for a small foundation dedicated to expanding health coverage. In August 2002, several consumer groups filed a lawsuit to block the conversion on the grounds that the state legislation authorizing it is unconstitutional. The Court dismissed the claims but outlined another viable constitutional claim: that the legislation violated New York's constitutional prohibition on "private" laws, defined in New York as legislation designed to benefit a single company. Plaintiffs have appealed the court's dismissal of their original claims and asserted, at the Court's invitation, the private-law constitutional claim. The state has cross-appealed.
Ohio	In late 1995, Community Mutual Insurance, one of two BCBS Ohio plans, merged with Anthem Insurance Companies with the approval of the Department of Insurance. In July 1996 the Attorney General initiated an investigation to determine whether charitable assets involved in the transaction should have been protected. After resisting pressure from community groups to open the investigation for public review, the Attorney General and Anthem reached a settlement in 1999. Anthem agreed to contribute $28 million to the Anthem Foundation, a newly-created healthcare foundation incorporated as an (a 509 (a)(3) supporting organization. Local community groups criticized the public process, the structure and governance of the foundation, the assumption to value only the Blue Cross assets and the misleading name of the foundation. In February 2001 Anthem filed its demutualization plan in Indiana, which was approved in October 2001, followed by the Anthem IPO.

The information provided in this chart is compiled by a nonprofit organization, Community Catalyst, which tracks health conversion and health issues in all states (see www.Communitycat.org).

X. OTHER ISSUES

A. Separate Alaska §501(c)(4) Foundation Shareholder

Establishing a second and separate §501(4) Alaska Foundation Shareholder to accept and monetize the New Premera shares may further weaken the rationale for IRS recognition of the 501(c)(4) tax-exempt status of each Foundation Shareholder. The added complexity of Foundation Shareholder coordinating on behalf of two states the sale of the New Premera Shares, investment of the cash proceeds and distributions to each state's Charitable Trust, strengthens the case (the non-tax business reasons) for recognition of a proper exempt purpose by the IRS. Establishing two 501(c)(4) organizations (especially without additional social welfare purposes, such as advocacy and healthcare policy objectives) may enhance the perception that the primary purpose of the two-tier structure is tax avoidance and that each 501(c)(4) is an "agent" of its corresponding Charitable Trust.

B. State and Local Tax matters

In general, each state in which assets are held or business is operated by an organization has a vested interest in the taxation of corporate reorganizations. Thus, it would be prudent to consider whether any tax imposed by either Washington, Alaska or any of either state's political subdivisions may be applicable so as to reach the assets, income or operations of the Foundation Shareholder or either Charitable Trust. It is important to note that a state's tax laws may not follow federal income tax treatment (and could impose taxes on an otherwise federal income tax exempt or deferred transaction). Some states also have procedures set up for sellers (or "transferors") to obtain tax certificates of good standing ("Tax Clearance Certificates") prior to the proposed transaction, wherein the state will certify the transferor's total liability for sales and income taxation. A state may also have local jurisdictions imposing certain taxes on a corporate reorganization (e.g., property taxation). A transferee of property in a

corporate reorganization should consider any transferee liabilities (e.g., income, sales, payroll, etc.) assumed under federal, state and local tax jurisdiction in connection with property acquired. These issues should be further analyzed to determine whether there are specific issues regarding material potential tax exposure and, if so, whether there is a mechanism (e.g. ruling process) to eliminate uncertainty.

C. Tax Reporting/Public Disclosure Matters

1. Form 990 vs. Form 990-PF

Private foundations are subject to a comprehensive regulatory scheme designed, in part, to provide greater accountability for private foundations and persons controlling them. Whereas social welfare organizations described in section 501(c)(4) generally are required to file annually with the Internal Revenue Service Form 990, Return of Organization Exempt From Income Tax, private foundations must file a lengthier annual return on Form 990-PF, Return of Private Foundation, with the Internal Revenue Service. Either form must be filed with the Internal Revenue Service by the 15th day of the 5th month – not including extensions – following the close of the organization's accounting period. Federal rules also require private foundations to forward the Form 990-PF to any state: (i) in which the principal office of the organization is located, (ii) the organization was incorporated or created, (iii) to which the organization reports in any fashion concerning its organization, assets or activities, or (iv) with which the organization has registered (or which it has otherwise notified in any manner) that it intends to be, or is, a charitable organization or a holder of property devoted to a charitable purpose.

Form 990 & Form 990-PF generally require the following information:

(i) general financial information, including its gross income, expenses, disbursements for exempt purposes, and beginning-year balance sheet;

(ii) identification of total contributions and gifts received along with the names and addresses of all substantial contributors;

(iii) disclosure of the names and addresses of its officers, directors, trustees, and key employees (including the details of compensation and other payments made to each of these individuals);

(iv) certain information in connection with lobbying efforts and transfers to exempt and political organizations; and

(v) additional information in connection with certain taxes as those applicable to lobbying and political expenditures and expenditures to influence legislation.

Private foundations must disclose additional information on Form 990-PF, such as:

(i) an itemized statement of its securities and all other assets, including their values;

(ii) an itemized list of all grants and contributions, including the name and address of the recipient and a concise statement of the purpose of each such grant or contribution; and

(iii) additional information applicable to excise taxes imposed on the private foundation's net investment income.

D. Public Disclosure Requirements

Annual Return and Exemption Application. An exempt organization, whether a social welfare organization, a public charity, or a private foundation, must make available for public inspection, upon request and without charge (except for copying costs), an exact copy of its original and amended, if any, three most recent year's annual information returns (e.g., Form 990 or Form 990-PF), and certain schedules, attachments, and supporting documents filed with the Internal Revenue Service. In addition, the exempt organization must also make available for public inspection without charge its application for federal income tax-exempt status (either IRS Form 1023 or Form 1024), which generally includes the application form, all documents and statements the Internal Revenue Service requires the organization to file with the form, any statement or other supporting document submitted by an organization in support of its application, and any letter or other document issued by the Internal Revenue Service concerning the application.

XI. CAVEATS AND LIMITATIONS

The aforementioned analysis in our report is based upon certain procedures approved by the OIC and performed by PricewaterhouseCoopers. The OIC is responsible for the sufficiency of the procedures as well as for drawing conclusions with respect to PwC's findings.

We make no representation regarding the sufficiency of our work either for purposes for which this report has been requested or for any other purpose. The sufficiency of the work we performed is solely the responsibility of the OIC, as are any decisions with respect to the proposed transaction. Had we been requested to perform additional work, additional matters might have come to our attention that would have been reported to you.

It is understood that this report is solely for the information of the OIC. PricewaterhouseCoopers' findings may be included in whole or in part in the record upon which any regulatory determination may be made by the OIC, which PricewaterhouseCoopers understands may be a matter of public record. If the OIC chooses to name PricewaterhouseCoopers in any report, the OIC should disclose that PricewaterhouseCoopers is not responsible for the sufficiency of the procedures for the purpose of the OIC's evaluation of the proposed transaction. PricewaterhouseCoopers' report will be intended solely for the information and use of the OIC and is not intended to be and should not be used by anyone else.

In addition to the foregoing, this report, or portions thereof, is not to be referred to or quoted, in whole or in part, in any registration statement, prospectus, public filing, loan agreement, or other agreement or document without our prior written approval, which may require that we perform additional work.